



BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Application of California-American Water Company (U 210 W) to Decrease Revenues for Water Service in its Coronado District by (\$73,100) or (0.46%) in 2008 and Increase Revenues by \$266,200 or 1.67% in 2009 and \$260,900 or 1.61% in 2010	A.07-01-036
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Larkfield District by \$1,272,000 or 61.91% in 2008, \$134,300 or 3.94% in 2009 and \$129,900 or 3.67% in 2010 Under the Current Rate Design or Decrease Revenues by (\$742,200) or (36.12%) in 2008 and Increase Revenues by \$50,000 or 3.72% in 2009 and \$63,500 or 4.55% in 2010 Under the Proposed Rate Design	A.07-01-037
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Sacramento District by \$8,966,900 or 33.89% in 2008, \$1,905,700 or 5.36% in 2009, and \$1,860,700 or 4.97% in 2010 Under the Current Rate Design or by \$10,981,000 or 41.50% in 2008, \$1,925,900 or 5.11% in 2009, and \$1,845,600 or 4.66% in 2010 Under the Proposed Rate Design	A.07-01-038
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Village District by \$1,537,300 or 7.43% in 2008, \$243,400 or 1.08% in 2009, and \$232,900 or 1.02% in 2010	A.07-01-039

**REPLY BRIEF OF CALIFORNIA-AMERICAN WATER COMPANY ON THE
REVENUE REQUIREMENTS**

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**REPLY BRIEF OF CALIFORNIA-AMERICAN WATER COMPANY ON THE
REVENUE REQUIREMENTS**

I. INTRODUCTION

Pursuant to Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission (“Commission”), California-American Water Company (“California American Water”) hereby submits its Reply Brief on the revenue requirements in the above-referenced proceeding.¹ This Reply Brief responds to the Opening Brief of the Division of Ratepayer Advocates (“DRA”), in which it opposes California American Water’s request for a

¹ The Commission bifurcated this proceeding to consider the revenue requirement issues first and consider the proposed rate design and water revenue adjustment mechanism (WRAM) in a second phase of the proceeding. See *Administrative Law Judge’s Ruling*, dated May 1, 2007 (“ALJ Ruling”), p. 1.

return on equity (“ROE”) of 11.5%, proposal for the Infrastructure System Replacement Surcharge (“ISRS”), proposed consolidation of the Sacramento and Larkfield Districts for ratemaking purposes and full recovery of the Regulatory Expenses and Employee Pension and Benefits expenses requested by California American Water. As discussed in more detail below, DRA’s proposals are without merit and do not further the Commission’s policies concerning the recovery of reasonable and prudently incurred costs and a fair and equitable return to shareholders, encouraging infrastructure replacement, making water affordable for customers in the long-term and reducing the impact in small, single districts of operation, maintenance and administrative costs. The Commission should reject DRA’s proposals and grant the relief requested by California American Water.

This Reply Brief also responds to the contentions of the Mark West Area Community Services Committee (“MWACSC”) regarding the proposed rate consolidation, the deficit in the Larkfield District water supply, the effect of conservation on that deficit, and three disputed capital projects in the Larkfield District.² With the exception of the consolidation proposal, which is addressed below, all of the issues raised by MWACSC will be covered by the settlement agreement between DRA and California American Water. As explained below, the Commission should give no weight to MWACSC’s self-styled Brief which suffers from gross misstatements of the record, improperly seeks to introduce new information that is not part of the record, and does little to address the real issues in this proceeding. MWACSC, through its admittedly lay, non-expert witness who has no experience in designing water facilities or water supply planning, makes numerous misleading and speculative assertions. Importantly, MWACSC fails to refute that there is an existing deficit in the water supply needs of the Larkfield District and that an additional water supply is prudent and necessary to ensure an

² California American Water files concurrently herewith a Motion to Strike MWACSC’s Opening Brief because it introduces new information that is not part of the record, inappropriately discloses information obtained through confidential settlement negotiations, and makes egregious and offensive statements that are not supported by the record.

adequate, reliable and dependable source of supply is maintained for the Larkfield District customers. Similarly, the Commission should reject MWACSC's frivolous and unmeritorious suggestion to institute an investigation into the design and construction of California American Water's North Wikiup Tank No. 2.

II. UNSETTLED ISSUES WITH DRA

A. Cost of Capital (Return on Equity).

Contrary to DRA's claims, the return on equity sought by California American Water is just and reasonable. California American Water is seeking a return that recognizes its financial risk and levels the playing field with regard to other Commission-regulated water companies. This return is supported by the facts, widely accepted financial policy and theory, and Commission precedent. By contrast, DRA's return on equity analysis is incomplete and its recommendation is discriminatory.

Although California American Water and DRA implemented the cost of equity estimation models somewhat differently to determine the correct return on equity, the key difference between the two parties is the treatment of financial risk. DRA again fails to justify the complete exclusion of financial risk from its analysis. Instead, DRA wastes much of the return on equity section of its Opening Brief on issues that are irrelevant and perpetuates errors and misconceptions from its flawed Cost of Capital Report. Additionally, certain statements positions taken by DRA in its Opening Brief are contradicted by its analyst's testimony at the evidentiary hearing.

As California American Water demonstrated in its Opening Brief, DRA's flawed analysis, contradictory statements and numerous errors affect DRA's credibility. DRA's Opening Brief does nothing to rectify that situation. The Commission should give little weight to DRA's recommendation and adopt California American Water's recommended 11.5% return on equity.

1. Risk-Reducing Regulatory Mechanisms Do Not Justify Excluding Financial Risk from the Return on Equity Analysis.

In its Opening Brief, DRA discusses factors that, in its opinion, indicate that California American Water has a low business risk.³ For several reasons, however, this discussion is not relevant to the Commission's ultimate return on equity recommendation. First, as California American Water explained in its Opening Brief, many of the regulatory mechanisms described by DRA are either not available to California American Water or still leave California American Water unprotected.⁴ Second, as DRA's analyst testified, business risk is basically the same for all California investor-owned water utilities.⁵ Therefore, the regulatory mechanisms discussed in DRA's Opening Brief do not mean that a lower than usual return is justified for California American Water. Third, as noted above, the difference between California American Water and DRA concerns the treatment of financial risk, not business risk. The regulatory mechanisms DRA discusses do not justify DRA's failure to include financial risk in its return on equity calculation. The Commission must address both business risk and financial risk in determining the correct return on equity for California American Water.

2. DRA's Failure to Address Financial Risk is Discriminatory.

In discussing the California American Water's financial risk, DRA's Opening Brief is understandably weak. DRA admits that the more debt a company has, the greater its financial risk.⁶ Although not mentioned in DRA's Opening Brief, since California American

³ Opening Brief of the Division of Ratepayer Advocates ("DRA Opening Brief"), pp. 8-9.

⁴ Opening Brief of California-American Water Company on the Revenue Requirements ("CAW Opening Brief"), p. 12. For example, the Commission has denied construction work in progress (CWIP) for California American Water's Coastal Water Project.

⁵ RT 286:13 – 287:16 (Willis/DRA). It could be argued, however, that the constraints of California American Water's Monterey District mean that its business risk is actually greater than other California water utilities. For the purpose of this analysis, however, California American Water agrees to assume that the business risk of all Commission-regulated Class A water utilities is the same.

⁶ DRA Opening Brief, p. 8.

Water has significantly more debt than comparable water companies, it follows that California American Water has significantly more financial risk.⁷ DRA also fails to mention that its analyst testified (and California American Water agrees), that investors require a higher return for investing in a water utility that has more debt.⁸ Finally, DRA does not provide an explanation in its Opening Brief for why it left an entire category of risk out of its return on equity calculation.

As California American Water discussed in its Opening Brief, its increased financial risk must be recognized in the adopted return on equity. California American Water's cost of capital rebuttal witness, Dr. Michael Vilbert, explained that review of after-tax weighted-average cost of capital reveals the difference between otherwise similarly situated water utilities and makes clear the need for a financial risk component in the return on equity analysis.⁹ The right cost of equity for a rate-regulated company in the same industry is a return that yields the same after-tax weighted-average cost of capital at the capital structure used to set the revenue requirement.¹⁰ If the Commission adopts DRA's recommendation, however, California American Water will have a significantly lower after-tax weighted-average cost of capital (assuming that each company has the same cost of debt).¹¹ Based on DRA's recommendation, the other publicly traded water utilities would receive an average of \$67.80 after-tax for every \$1,000 of investment in rate base whereas the California American Water districts would receive only \$61.70 after-tax.¹² DRA offers no justification for this discriminatory treatment.

⁷ Exh. 29, DRA Cost of Capital Report, Table 2-1.

⁸ Exhs. 4, 8, 10, 12, Reiker Direct, p. 31; RT 288:2-12 (Willis/DRA).

⁹ Exh. 24, Vilbert Rebuttal, pp. 5-6.

¹⁰ Exh. 24, Vilbert Rebuttal, pp. B25-26.

¹¹ *Id.*, p. 15; *see* Opening Brief, p. 5.

¹² The cost per \$1,000 of investment is estimated as the product of the after-tax weighted-average cost of capital from Table 4 times \$1,000. The difference is even more striking for privately owned California water companies, which have an after-tax weighted average cost of capital of 7.62%. (Exh. 24, Vilbert Rebuttal, p. 13, Table 5.)

DRA argues that California American Water can avoid this discriminatory treatment by adjusting its capital structure to reduce its amount of debt. DRA, however, recognizes in its Cost of Capital Report that California American Water's capital structure is reasonable.¹³ It is counterintuitive to penalize a utility for a reasonable capital structure. Moreover, because of California American Water's low cost of debt, its customers benefit from its more leveraged capital structure. As DRA noted, the forecast cost of debt for California American Water is less than the DRI forecast cost of debt for A-rated utilities.¹⁴ This is clearly in the interest of the customers, but this benefit is only possible if a strong credit rating is maintained by the entity issuing the debt. In its eagerness to deny California American Water a financial risk component, DRA is willing to give up significant benefits for California American Water customers.

3. DRA Violates the Legal Standards for Return on Equity.

DRA pays lip service to *Bluefield*¹⁵ and *Hope*,¹⁶ but does not include a discussion of the legal standards for rates of return in its Opening Brief. This is likely because DRA's exclusion of financial risk from its analysis runs afoul of these standards.

First, DRA's return on equity recommendation does not meet the "comparable earnings standard" set forth by the Supreme Court in *Bluefield* and affirmed in *Hope*.¹⁷ Under the comparable earnings standard, if two companies are similar in terms of business risk,

¹³ Exh. 29, DRA Cost of Capital Report, p. 2-8.

¹⁴ *Id.*

¹⁵ *Bluefield Water Works & Improvement Co. v. Pub. Service Comm. of the State of Virginia* (1923) 262 U.S. 679.

¹⁶ *Federal Power Comm. v. Hope Natural Gas Co.* (1944) 320 U.S. 591.

¹⁷ *Bluefield*, 262 U.S. at 692-693; *Hope*, 320 U.S. at 603. The comparable earnings standard states that the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.

investors will expect a higher return for investing in the firm that has more debt. Since DRA did not include a financial risk component to address California American Water's higher level of debt, it did not meet the comparable earnings standard.

Second, DRA's recommended return on equity also violates the standards of financial integrity and capital attraction as set forth by the Supreme Court in *Bluefield* and affirmed in *Hope*.¹⁸ A utility is entitled to a return that will allow it to maintain its credit so that it continues to have access to the capital markets to raise the funds necessary for investment. As DRA's analyst conceded, an investor would not want to invest in a company that has a return on equity that does not reflect its financial risk.¹⁹

As it did in its Cost of Capital Report, DRA in its Opening Brief attempts to sidestep this legal standard by citing the credit-worthiness of American Water Capital Corporation.²⁰ However, the credit rating of American Water Capital Corporation cannot be sustained if each of American Water's subsidiaries is regulated as if there is no need to provide a rate of return on equity consistent with that rating. As DRA's analyst testified, failure to provide the return on equity commensurate with financial risk could cause a company's credit rating to go down.²¹ If American Water Capital Corporation is to sustain its rating, each subsidiary must provide support for the rating. DRA's recommendation fails to provide that support.

4. Commission Precedent Supports a Financial Risk Component in the Return on Equity Analysis.

Although DRA has arbitrarily decided to adopt a policy of excluding financial risk from its return on equity analyses,²² its Opening Brief shows that the Commission is not as

¹⁸ *Bluefield*, 262 U.S. at 693; *Hope*, 320 U.S. at 603-605.

¹⁹ RT 293:27 – 294:3 (Willis/DRA).

²⁰ Exh. 29, DRA Cost of Capital Report, p. 3-4; DRA Opening Brief, p. 10.

²¹ RT 294:19-21 (Willis/DRA).

²² "I am not going to recommend a risk premium for any company." RT 289:21-22 (Willis/DRA)
(continued...)

proceeding, Dr. Vilbert provided a detailed analysis of the after-tax weighted-average cost of capital, an analysis that was not provided in the Monterey case. This analysis shows that that a financial risk component resulting in an 11.5% return on equity is necessary to reflect California American Water's capital structure and avoid discriminatory treatment.²⁸ Although DRA claims in its Opening Brief that California American Water's financial risk component is too high, it does not provide an alternate analysis to support its statement. DRA criticizes California American Water's result, but does not address how to calculate a financial risk component, should the Commission deem one necessary. The record in this proceeding supports California American Water's financial risk component and recommended return on equity, which the Commission should adopt.

Moreover, the Commission's recent decision in the Valencia Water Company ("Valencia") general rate case, also cited by DRA in its Opening Brief, demonstrates the Commission's willingness to adjust a company's return on equity to address risk.²⁹ In that decision, the Commission held that Valencia's small size as compared to other Commission-regulated Class A water utilities justified a risk adjustment to the Valencia's return on equity. The Commission authorized an upward adjustment almost three times greater than that authorized in the 2003 Monterey decision.³⁰

Just as there is a significant difference in size between Valencia and other Class A water utilities, there is a significant difference in amount of debt between California American Water and other Class A water utilities. In both instances, these differences result in differences in the level of risk. Just as the Commission included Valencia size-related risks in Valencia's

²⁸ Exh. 24, Vilbert Rebuttal, pp. 15-16.

²⁹ D.07-06-024, *Opinion on Application for General Rate Increase* (June 21, 2007), *mimeo*.

³⁰ *Id.*, *mimeo*, pp. 28, 50.

adopted return on equity, it should include California American Water's increased financial risk in the return on equity for California American Water.

5. DRA's Discussion of Energy Utilities and VS Growth is Irrelevant.

Instead of addressing the important issues surrounding financial risk, DRA wasted time in its Opening Brief bringing up the issue of California American Water's use of electric and gas utilities.³¹ At the evidentiary hearing, DRA's analyst stated that using gas and electric utilities as a reasonableness "check" was an acceptable use of electric and gas utility data.³² As California American Water made clear in its testimony and in its Opening Brief, it did not use electric and gas utilities as part of its return on equity calculation, but rather as a check to see if its analysis was reasonable.³³ California American Water is well aware that the Commission frowns upon the use of electric and gas utilities in the underlying return on equity analysis. However, since that is not what California American Water did, and since DRA's analyst expressed support for the manner in which California American Water did use the electric and gas data, it is unclear why DRA devoted so much of its Opening Brief to this issue.

Similarly, DRA spends several paragraphs discussing California American Water's use of VS growth in its discounted cash flow (DCF) forecast.³⁴ Use of VS growth is justified because, as California American Water demonstrated, the average market-to-book ratio of sample companies indicates that they are not expected to issue future shares at prices equal to book value.³⁵ Moreover, contrary to DRA's implication,³⁶ California American Water's use of

³¹ DRA Opening Brief, pp. 6-8.

³² RT 300:2-6 (Willis/DRA).

³³ Exhs. 4, 8, 10, 12, Reiker Direct, p. 11; Opening Brief, pp. 10-11.

³⁴ DRA Opening Brief, pp. 5-6.

³⁵ Exhs. 4, 8, 10, 12, Reiker Direct, p. 16, JMR-14, JMR-39, JMR-63.

³⁶ Exh. 29, DRA Cost of Capital Report, p. 4-1.

VS growth does not include issuance costs. Finally, California American Water's requested 11.5% return on equity would be justified even if the Commission rejected the use of VS growth. California American Water and DRA's underlying return on equity analyses are consistent, but for DRA's failure to account for financial risk. Dr. Vilbert used DRA's results, which did not include VS growth, in his return on equity analysis, and concluded that not only was an 11.5% return on equity reasonable, but that actually a slightly higher return would be justified.³⁷ Therefore, DRA's discussion of VS growth is immaterial.

While DRA recognizes the impact of financial risk on return on equity, it failed to include any financial risk component in its recommendation. In effect, it stopped short before its return on equity analysis was complete. It is this failure that accounts for the difference between California American Water's 11.5% recommended return on equity and DRA's 9.96% recommendation. DRA's omission of financial risk is arbitrary and is not based on any principle of financial theory or analysis. Moreover, it violates the legal standards for rate of return. The Commission should reject DRA's capricious exclusion of financial risk and adopt the California American Water's recommended return on equity.

B. Special Request #1 – ISRS

California American Water's ISRS proposal provides tangible customer benefits, provides greater customer protections than the current ratemaking process, and affords California American Water with the financial and operational flexibility to continue providing high levels of customer service. DRA incorrectly claims that California American Water has not demonstrated benefits to customers, sufficient safeguards to protect customers against the "risk" of imprudent expenditures, or the need for the ISRS program.³⁸ DRA's claim, however, is

³⁷ Exh. 24, Vilbert Rebuttal, p. 15.

³⁸ Opening Brief of the Division of Ratepayer Advocates ("DRA Opening Brief"), pp. 11, 15-20.

contradicted by the vast record of evidence in this proceeding that demonstrates the tangible and potentially material benefits to customers of ISRS, which include: (1) starting off a three-year rate cycle with a lower rate increase and stabilizing rate increases; (2) additional safeguards that are not part of the normal ratemaking process to protect customers from paying for imprudent costs; and (3) ensuring customers that a portion of each bill will be spent exclusively on long-term infrastructure replacement. The Commission should adopt the ISRS program, as proposed by California American Water, and allow California American Water to begin necessary infrastructure replacement, which furthers the Commission's important policy of promoting water infrastructure replacement in California.

1. ISRS Benefits Customers by Establishing Lower Base Rates and Stabilizing Rate Increases.

DRA's repeated claims that ISRS will not provide any additional benefits to customers that are not currently available under the existing regulatory framework are belied by evidence that ISRS will provide significant and direct benefits to customers.

ISRS will provide the significant customer benefit of allowing customers to start out the rate case cycle with a lower rate increase.³⁹ Under the current ratemaking methodology for general rate cases, customers begin paying rate increases as if the plant were already constructed and in service, when in fact approved plant additions may not be placed in service for another year or two.⁴⁰ That is because utilities currently forecast plant additions for test years and authorize an upfront revenue requirement that includes the forecasted plant additions. If ISRS is adopted, California American Water will remove the proposed expenditures for ISRS-class projects from the calculation for the rate base and seek to begin recovery of the project

³⁹ DRA Opening Brief, p. 14. At page 15 of its Brief, DRA concedes that customers "may benefit from new infrastructure" under ISRS, although any rewards to customers are "scant."

⁴⁰ Exh. 25, Rebuttal Testimony of David P. Stephenson ("Stephenson Rebuttal"), p. 22:5-7.

costs through the ISRS program only after the projects are completed and operational.⁴¹ Only after the ISRS project is in operation will its capital and associated costs be recovered via a surcharge on customer's bills. The ISRS surcharges will be based on the actual, not estimated or forecasted, costs of eligible construction completed and placed in service prior to the implementation of an ISRS surcharge.⁴²

That is why, as DRA acknowledges, base rates will be lower if the Commission adopts California American Water's ISRS program.⁴³ DRA argues that the lower base rates at the beginning of the rate cycle is not a customer benefit and is, instead, "a virtually meaningless argument from a ratepayer's point of view."⁴⁴ In making this claim, DRA ignores evidence that as a result of customers not paying for improvements until they are in service, customers will pay lower overall rates even with the ISRS surcharge in place.⁴⁵ DRA reasons that if California

⁴¹ Application of California-American Water Company to Increase Revenues in its Sacramento District ("Sacramento Application"), Exh. A, Chap. 1, Sec. 4, p. 2; Application of California-American Water Company to Increase Revenues in its Larkfield District ("Larkfield Application"), Exh. A, Chap. 1, Sec. 4, p. 2; Application of California-American Water Company to Increase Revenues in its Village District ("Village Application"), Exh. A, Chap. 13, Sec. 1, p. 1; Application of California-American Water Company to Increase Revenues in its Coronado District ("Coronado Application"), Exh. A, Chap. 13, Sec. 1, p. 1; Exh. 3, Direct Testimony of James E. Harrison in the Sacramento District ("Sacramento Harrison Direct"), p. 3:21-24, 19:12-16; Exh. 8, Direct Testimony of James E. Harrison in the Larkfield District ("Larkfield Harrison Direct"), p. 3:22-25, 19:19-23; Exh. 10, Direct Testimony of James E. Harrison in the Village District ("Village Harrison Direct"), p. 3:21-24, 19:17-21; Exh. 12, Direct Testimony of James E. Harrison in the Coronado District ("Coronado Harrison Direct"), p. 3:21-24, 19:17-21; Exh. 7, Direct Testimony of David P. Stephenson in the Sacramento District ("Sacramento Stephenson Direct"), p. 16:2-9; Exh. 9, Direct Testimony of David P. Stephenson in the Larkfield District ("Larkfield Stephenson Direct"), p. 15:22-16:2; Exh. 11, Direct Testimony of David P. Stephenson in the Village District ("Village Stephenson Direct"), p. 15:19-25; Exh. 13, Direct Testimony of David P. Stephenson in the Coronado District ("Coronado Stephenson Direct"), pp. 15:27-16:5.

⁴² Exh. 3, Sacramento Harrison Direct, p. 3:21-23; Exh. 8, Larkfield Harrison Direct, p. 3:22-24; Exh. 10, Village Harrison Direct, p. 3:21-23; Exh. 12, Coronado Harrison Direct, p. 3:21-23.

⁴³ DRA Opening Brief, p. 20.

⁴⁴ DRA Opening Brief, p. 20.

⁴⁵ Exh. 23, Stephenson Rebuttal, p. 21:9-15

American Water's ISRS program is adopted, customers' bills will begin to increase in an "erratic" manner.⁴⁶ DRA has grossly mischaracterized the small, steady rate increases under the proposed operation of the ISRS program which total 3.33 percent annually over the three year rate cycle. The ISRS program will not result in "erratic" surcharge increases, but will instead create rate stability by normalizing the cost of capital improvements that may become necessary in large clusters. Additionally, the ISRS program will result in small incremental rate changes rather than the larger increases that results under the current Rate Case Plan, and thereby promote phased-in rate increases. ISRS will provide an available steady stream of revenue requirement recovery for inevitable infrastructure replacement costs, which will prevent spikes in customer rates. Again, the revenue requirement recovery will only be on customers bills for completed and in service projects. DRA strangely implies that customers would somehow be better off paying an increased rate regardless of whether the underlying project is actually built.⁴⁷

Under California American Water's proposal, the surcharge will be capped at 3.33% annually with a three year 10% cap of the total revenues. DRA incorrectly claims that the cap proposed by California American Water is higher than the surcharge adopted in other states. The proposed price cap as proposed by California American Water will average approximately 3% per year during the three years the proposed base rates will be in effect. In comparison, the cap for the ISRS-type surcharge authorized in Pennsylvania was a five percent cap.⁴⁸ In any event, California American Water's ISRS program will cover more plant (including wells,

⁴⁶ DRA Opening Brief, p. 20.

⁴⁷ DRA Opening Brief, p. 20.

⁴⁸ The fact that Pennsylvania American Water chose not to file a rate case for a two-year period when it could file one every year does not change the fact that the company was authorized to implement a surcharge of five percent. *See* RT 347:15-19 (Harrison/CAW). Mr. Harrison also testified that Pennsylvania American Water could implement any combination of surcharge that did not exceed five percent. *See* RT 349:16-28 (Harrison/CAW).

pumps, motors and other items) than was covered by the Pennsylvania ISRS-type program, which included only plant related to transmission and distribution.⁴⁹

Without any justification, DRA recommends that, if the Commission approves the ISRS proposal in this proceeding, the Commission should adopt a 7% cap instead of California American Water's proposed 10% cap.⁵⁰ California American Water has demonstrated that a 10% cap would produce only modest incremental rate increases,⁵¹ and have far less impact on customers than the annual rate increases under the current ratemaking methodology. Moreover, the 10% cap would allow California American Water to pursue needed infrastructure replacement projects, including newly-identified or emergency infrastructure replacement not specifically identified in the Application, and to charge reasonable rates to undertake the system infrastructure replacement necessary in the four Districts.

Rather than making water bills unpredictable and disrupting the management of personal household budgets, as DRA alleges,⁵² the ISRS program's evenly distributed rate increase will actually assist customers manage household budgets and adjust to unavoidably rising costs. The incremental rate increases under ISRS create additional customer benefits in that such increases provide more predictability for customers than the possible rate spikes resulting from larger tri-annual increases under the traditional process.

Finally, DRA's seriously misleading assertion that California American Water's ISRS proposal primarily benefits shareholders is entirely without merit.⁵³ Contrary to DRA's

⁴⁹ Exh. 3, Sacramento Harrison Direct, p. 4:12-26; Exh. 8, Larkfield Harrison Direct, p. 4:14-28; Exh. 10, Village Harrison Direct, p. 4:12-26; Exh. 12, Coronado Harrison Direct, p. 4:12-26.

⁵⁰ DRA Opening Brief, p. 26.

⁵¹ See e.g. California American Water's Opening Brief ("CAW Opening Brief"), p. 20 (discussing the amount of the estimated initial surcharge to be between eight and 24 cents).

⁵² DRA Opening Brief, p. 20.

⁵³ DRA Opening Brief, 14.

claim, nowhere does the Water Action Plan state or even suggest that the company would be the “primary beneficiary” of ISRS.⁵⁴ DRA provides no evidentiary support for the claim that the ISRS proposal will benefit California American Water shareholders. On the contrary, the record is replete with evidence that while ISRS will provide significant benefits to customers it will not provide corresponding benefits to shareholders.⁵⁵ First and foremost, as Mr. Stephenson testified, because customers do not begin paying for the ISRS projects until they are completed and in service (used and useful), if California American Water completes exactly the same projects, California American Water “will not recover as great a revenue through ISRS as it would under the standard ratemaking process in California.”⁵⁶ Contrary to DRA’s incorrect assertion that ISRS should reduce regulatory lag, the record demonstrates that ISRS, as proposed by California American Water, will increase the risk for regulatory lag by automatically postponing the recovery of the revenue requirement for ISRS projects by more than a quarter.⁵⁷

2. ISRS Benefits Customers By Ensuring that Customers Do Not Pay Imprudently Incurred Costs.

The ISRS proposal contains numerous customer safeguards and, indeed, provides more customer protections than the current ratesetting process. Each ISRS project will still be subject to review by DRA and the Commission, and will now be reviewed by Water Division. As set forth in California American Water’s Opening Brief, these safeguards include: California American Water will file quarterly advice letters detailing the investments undertaken in the prior quarter; the Commission’s Water Division will review the quarterly filings and authorize, modify or disallow recovery of ISRS; the surcharge will have a price cap of ten percent of the

⁵⁴ DRA Opening Brief, p. 14.

⁵⁵ RT 361:2-4 (Stephenson/CAW) (testifying that “I’m not sure that the investment market would view it [ISRS] one way or the other. There wouldn’t be any impact.”).

⁵⁶ RT 360:21-24 (Stephenson/CAW).

⁵⁷ RT 363:23- 364:4 (Stephenson/CAW).

total revenues over the three-year rate case cycle; and DRA, intervenors and the Commission will have the opportunity to review the actual expenditures for reasonableness.⁵⁸ These safeguards will ensure that customers do not pay for imprudent ISRS expenditures. DRA erroneously contends that California American Water's ISRS proposal will limit the review of ISRS expenditures to an after-the-fact examination.⁵⁹ This is simply untrue. California American Water's ISRS will be reviewed both before the surcharge goes into effect through the advice letter process and again after the surcharge goes into effect. The Commission may also exercise its audit authority at any time to review California American Water's records.

ISRS will in no way circumvent or minimize the Commission's regulation of California American Water's investments, operations, and rates. There is simply no evidence to support DRA's contention that if the ISRS program is adopted the Commission would be more likely to allow California American Water to recover imprudent expenses because "[i]t just wouldn't be a popular position for the Commission to take."⁶⁰ It is for this Commission to determine what expenses are prudent and imprudent and in making such a determination the Commission should never base its decision upon political concerns. The Commission is not going to shirk its duty to customers and allow recovery of imprudent costs because it is worried about being unpopular. DRA should have more confidence in the Commission's commitment to protect customer interests. In making this claim, DRA ignores the fact that it is constantly asking the Commission to disallow ongoing costs, as it has done in this rate case, and presumably DRA's review of actual costs would be no different than its review of ongoing costs.

DRA mistakenly argues that ISRS will provide California American Water with a less predictable and accurate revenue calculation compared to traditional ratemaking.⁶¹ DRA

⁵⁸ CAW Opening Brief, pp. 16-18, 20-21.

⁵⁹ DRA Opening Brief, p. 13.

⁶⁰ DRA Opening Brief, p. 24.

⁶¹ DRA Opening Brief, pp. 18-19.

needs only to review the record evidence to see that the Commission's review of actually incurred costs and completed projects provides far more customer protections and a more accurate and predictable revenue calculation than the current forecasting method utilized by the Commission in traditional ratemaking. Under the current ratemaking process, California American Water must timely and accurately predict needed infrastructure replacement projects, forecast the cost of those projects based on current costs for labor, materials, and other expenses, and seek Commission pre-approval of those projects in its tri-annual GRC applications. DRA reviews those forecasts, analyzes California American Water's projections, and may conduct its own forecasts and projections. A multi-year forecast for ISRS-eligible (and other) investments necessarily involves a significant degree of uncertainty. Furthermore, as Mr. Stephenson testified, "the accuracy of forecasting revenues for financial planning purposes is not only dependent upon all elements of the base rate calculations remaining the same during each year of the planning period, but the component of those revenues associated with the fixed costs of ISRS-eligible additions must also be identified."⁶² The ISRS proposal, on the other hand, emphasizes review of actually incurred costs, not preliminary estimates or projections. Contrary to DRA's claims, ISRS provides more effective customer protections than the current general rate case review and approval process.

One of the overarching themes in DRA's Opening Brief is that after-the-fact review of ISRS investments is inadequate.⁶³ To that end, DRA claims that the proposed settlement between DRA and California American Water in this rate case lends support for the proposition that review of projects should take place before they are completed because it "often results in a significant reduction in rates."⁶⁴ Because the proposed reductions are the result of

⁶² Exh. 7, Sacramento Stephenson Direct, p.13:4-8; Exh. 9, Larkfield Stephenson Direct, p. 12:24:28; Exh. 11, Village Stephenson Direct, p. 12:21-25; Exh. 13, Coronado Stephenson Direct, p. 13:1-5.

⁶³ DRA Opening Brief, pp. 22-23.

⁶⁴ DRA Opening Report, p. 23.

confidential negotiations that have not yet been finalized, much less approved by the Commission, the Commission should disregard DRA's misguided attempt to use the proposed settlement in this manner. In truth, after the fact review and disallowances are commonplace under the current regulatory scheme. For example, the Commission may order a utility to track the costs of a particular highly uncertain project in a memorandum account. Once the project is complete, the Commission has the opportunity to review the project costs for reasonableness and disallow certain costs if necessary. Similarly, advice letter projects (which are for projects with uncertain timing or cost), which DRA says provide comparable benefits to ISRS, also allow for after the fact review and disallowances.

In reality, customers are at greater risk of paying for imprudent investments under the current rate case process than under the ISRS proposal. Under the current regulatory framework, DRA and the Commission review proposed investments and projected costs. DRA and the Commission currently spend significantly less time scrutinizing the actual expenditures of projects completed in the prior rate cycle – those expenditures are generally given a cursory review.

As noted in California American Water's Opening Brief, qualifying ISRS projects must "a) replace existing distribution system and infrastructure facilities; b) result in no significant additional revenues; [and] c) **do not materially change operating expenses.**"⁶⁵ Additionally, ISRS involves the replacement of existing facilities, not the construction of new or controversial facilities.⁶⁶ Capital projects that would fall under the ISRS program include the recurrent projects for replacement of networks, hydrants, service lines, meters, and process plant, and investments for additional pumps, small main replacement, larger main replacement and installation, pump equipment improvements, and well improvements.⁶⁷ Any customer risk of

⁶⁵ Exh. 23, Stephenson Rebuttal, p. 21: 4-7.

⁶⁶ Exh. 23, Stephenson Rebuttal, pp. 20-21.

⁶⁷ See e.g. Exh. 3, Sacramento Harrison Direct, p. 4; Exh. 8, Larkfield Harrison Direct, p. 4;
(continued...)

paying for imprudently incurred costs is even more diminished in the case of these types of routine infrastructure replacement projects.

In light of the evidence presented, the Commission should find that California American Water's ISRS proposal more than adequately protects customers.

3. ISRS Ensures Customers That a Portion of Each Bill Will Be Spent Exclusively on Long-Term Infrastructure Replacement.

ISRS ensures customers that a portion of each bill will be spent exclusively on long-term infrastructure replacement. DRA asserts that customers are not significantly concerned with the general state of their water system.⁶⁸ California American Water disagrees and believes that customers place a very high priority on an efficiently operating water system. This is especially true given the ever-increasing costs to purchase water for California American Water's service areas. Moreover, the Commission's own policy statement and the undisputed record evidence in this proceeding are in accord that water utilities in California should be focusing on long-term system infrastructure replacement as facilities are nearing or at the end of their useful lives.⁶⁹ Based on the history of DSIC-like surcharges in other states, customer complaints regarding the infrastructure replacement surcharge on their bills are reported to be "virtually non-existent" and, indeed, the surcharges were "received favorably by customers."⁷⁰

DRA's contention that ISRS "is just a different way of collecting from customers" belies its misunderstanding of California American Water's ISRS proposal.⁷¹ As explained in

(continued...)

Exh. 10, Village Harrison Direct, p. 4; Exh. 12, Coronado Harrison Direct, p. 4.

⁶⁸ DRA Opening Brief, p. 19.

⁶⁹ Water Action Plan, pp. 4, 12-15.

⁷⁰ Exh. 3, Sacramento Harrison Direct, p. 24:1-15; Exh. 8, Larkfield Harrison Direct, p. 24:10-24; Exh. 10, Village Harrison Direct, p. 24:6-20; Exh. 12, Coronado Harrison Direct, p. 24:6-20; RT 340:21-28 (Harrison/CAW) (testifying that he was not aware of any formal complaints arising from the implementation of an ISRS-type charge in Pennsylvania (DSIC)).

⁷¹ DRA Opening Brief, p. 18.

the Opening Brief, the ISRS program provides California American Water with significant flexibility with managing its budget for infrastructure replacement and adapting to the needs of the water system, which will ensure the continuation of the excellent reliability and water service to California American Water's customers.⁷²

4. The Commission Should Not Delay the Implementation of California American Water's Proposed ISRS Program.

Through the adoption of the Water Action Plan, the Commission recognized the need to promote higher levels of infrastructure replacement in the coming years and noted that new methods and approaches may be necessary to do so.⁷³ DRA contends that replacing water aging infrastructure is already "a normal component of the utility's on-going responsibilities" and suggests that the current regulations provide a proper mechanism to accelerate the water industry's replacement needs.⁷⁴ The Water Action Plan contradicts, rather than supports, DRA's assertion that the traditional ratemaking process already provides adequate incentives to water utilities for water infrastructure investment. The Water Action Plan recognizes that given the age of the infrastructure in California, water utilities and their customers cannot afford to defer implementing comprehensive plans to replace their deteriorating system infrastructure. Consistent with the goals identified in the Water Action Plan to promote infrastructure investment and streamline Commission regulatory decision making, California American Water wants to make sure that its customers continue to enjoy their current high-quality water service by undertaking infrastructure replacement now, rather than waiting until mains break and service is interrupted, and a succession of emergency repairs are required.

⁷² CAW Opening Brief, pp. 22-23.

⁷³ Water Action Plan, pp. 12-15 ("Objective: Promote Water Infrastructure Investment") and pp. 20-22 ("Objective: Set Rates that Balance Investment, Conservation, and Affordability").

⁷⁴ DRA Opening Brief, pp. 14-15.

Furthermore, as set forth in its Opening Brief, California American Water has presented testimony on the need to replace the aging infrastructure in its four Districts. Large sections of the water systems in the four Districts were installed at the same time (*e.g.*, over 60 and 70 years ago in many districts and over 80 years in the Coronado District), therefore, they have almost identical service lives and will deteriorate at nearly identical rates.⁷⁵ Accordingly, as substantial segments of the water systems in certain areas are now reaching or are at the end of their expected useful lives, large segments of the water system will need almost simultaneous replacement. DRA's own evidence demonstrates that the need for long-term infrastructure replacement is an industry-wide problem.⁷⁶ DRA's assertion that California American Water has failed to provide evidence of specific infrastructure replacement needs in its water system misses the larger issue that replacing even small portions of a water system will cost millions and that the Commission cannot afford to delay the implementation of ISRS.

DRA misguidedly urges the Commission to withhold approval of the ISRS proposal until California American Water has developed a comprehensive review and analysis of infrastructure replacement and upgrade needs, including details on the "number of wells, water treatment plant, distribution mains, services and other facilities that may fall under an ISRS; criteria used to determine when facilities will need replacement; estimates or forecasts identifying the level of capital investment planned; the effect of national security or drinking water standards on infrastructure replacement."⁷⁷ Requiring California American Water to provide this level of detail before it implements ISRS will hardly streamline the existing Commission process.

⁷⁵ CAW Opening Brief, pp. 24-25.

⁷⁶ Exh. 43, NARUC Resolution Supporting Consideration of Regulatory Policies Deemed as "Best Policies" (cited in Exh. 25, DRA Report on the Results of Operations for Sacramento ("Sacramento DRA Report"), p. 11-5).

⁷⁷ DRA Opening Brief, p. 25, n. 13.

DRA urges the Commission to delay implementing ISRS despite the fact that California American Water's proposal is a trial program which would apply to specific plant additions that have been reviewed in this rate case. There is no reason to wait to implement the ISRS program. California American Water made its traditional substantial upfront showing for all of its projects in the rate case, even projects that would fall under the ISRS program. California American Water did so because it did not know whether the Commission would adopt the ISRS program. These projects were then thoroughly reviewed by California American Water and were the subject of lengthy settlement negotiations. It is inefficient, however, to expend this level of resources on ISRS projects, which are routine replacements of existing infrastructure. The ISRS program is needed to maximize the efficiency of the process.

If the Commission authorizes the ISRS program as part of the current rate case, DRA and the Commission will have had the unique opportunity to pre-approve the ISRS projects. In the next GRC, all parties will have the ideal opportunity to examine whether it provides the right balance between customer protection and utility incentives, as California American Water believes it will. As part of its next general rate case filing, California American Water will make a showing to justify the continued authorization of the ISRS program. Since DRA has already agreed to the reasonableness of the specific ISRS projects for the upcoming rate case cycle, there is no need to delay authorization of the ISRS program. California American Water urges the Commission to approve the ISRS proposal. If, in the next GRC proceeding, the Commission believes that improvements to the ISRS program can be made, then at least those improvements will be based on actual evidence of the efficiencies, customer benefits, and shortcomings of the ISRS as implemented in this case.

Finally, DRA contends that California American Water has not shown that the current ratemaking scheme is inadequate to address unanticipated replacements.⁷⁸ There is

⁷⁸ DRA Opening Brief, p. 15.

currently no ratemaking mechanism in place that provides all of the benefits of ISRS, including delaying implementation of rate increases, an ongoing level of new investment for routine infrastructure replacements and upgrades, and a separately identified revenue stream for infrastructure investment.

DRA incorrectly contends that this Commission already utilizes a number of policies and mechanisms to satisfy California American Water's (and other water utilities') needs for infrastructure replacement without an ISRS. As an initial matter, DRA's position is contradicted by its own testimony in this proceeding that there is a **"well-identified problem (specifically that the existing regulatory framework does not provide a revenue stream for the cost of replacing and maintaining its necessary but non-revenue producing portions of plant)"**.⁷⁹ California American Water fundamentally disagrees with DRA's position that the existing regulatory framework provides adequate solution for this problem. While DRA recommends "alternative methods to streamline Commission approval for water utility capital investments that are used to replace aging infrastructure," it fails to cite any policies and mechanisms in its Brief that will achieve the necessary results other than an ISRS-type charge. For example, the Commission's use of construction work in progress (CWIP) provides no greater recovery of investment costs than allowing plant in service;⁸⁰ CWIP is an estimate, just like the current estimate for plant additions.

DRA appears to suggest that specific recurring line items used for emergency projects should enable California American Water to make all unanticipated replacements.⁸¹ The current ratemaking process requires California American Water to often substitute pre-authorized projects for emergency projects, in order to remain within the authorized revenue requirement.

⁷⁹ Exh. 25, Sacramento DRA Report, p. 11-1 (emphasis added to original).

⁸⁰ DRA Opening Brief, p. 17.

⁸¹ DRA Opening Brief, p. 15.

As a result, construction on the previously-authorized project is slowed or even postponed until the next rate case cycle. DRA may not recommend these “switched” or “postponed” projects, even when they were necessitated by emergencies.⁸² Furthermore, contrary to DRA’s claim that these emergency funds can be used to handle all emergencies, the emergency replacement of a larger main cannot be covered with the budgeted dollar for specific recurring line items and requires California American Water to forego earnings for a period of time.

While California American Water expects that its projections in its past and current general rate cases are sound, as time goes on and infrastructure systems age and deteriorate more replacements will be necessary on an emergency basis. That is exactly what the ISRS program seeks to address; it will afford California American Water the operational flexibility required to undertake investments as needs arise. California American Water (and its customers) should not be forced to choose between pursuing pre-approved projects and urgent replacement projects.

5. DRA’s Needless Modifications to the ISRS Program Must be Rejected.

Instead of increased regulatory flexibility, DRA’s recommendations to the ISRS program will only provide additional administrative headaches. The ISRS program, as set forth in DRA’s Brief, will not advance Water Action Plan objectives, nor would other utilities consider it a model to emulate. In the name of “regulatory oversight” DRA proposes to modify the ISRS program to the point that instead of streamlining the Commission process, it provides significant additional administrative burdens. In addition to the requirements of an infrastructure replacement strategy and Tier 3 Advice Letter process discussed below, DRA proposes to impose additional requirements on the ISRS program, including additional reporting, audits,

⁸² Exh. 7, Sacramento Stephenson Direct, p.21:1-17; Exh. 9, Larkfield Stephenson Direct, p. 20:19-21:8; Exh. 11, Village Stephenson Direct, p. 20:11-28; Exh. 13, Coronado Stephenson Direct, p. 20:21-21:12.

customer notifications, and other administrative burdens that are not currently required of California American Water in the traditional regulatory scheme. California American Water opposes these additional requirements because they (1) increase regulatory burdens and resource expenditures; (2) remove administrative efficiencies and increase the potential for delayed recovery in rates, which will further erode California American Water's earnings; and (3) unnecessarily limit California American Water's flexibility with the ISRS pilot program.

Simply put, the proposed ISRS program already provides less revenues than California American Water would otherwise earn under the traditional regulatory scheme and California American Water is not willing to implement a program that will require it to make additional resource expenditures and further erode its earnings. Imposing DRA's proposed modifications to the ISRS program will send the strong signal to water utilities that the reward for making innovative proposals to further the goals of the Water Action Plan is increased regulatory burdens and resource expenditures.

a. The Requirement to Develop an Infrastructure Replacement Strategy for the ISRS Programs in California American Water's Long-Term Capital Asset Management Planning is More Acceptable in the Long-Term.

DRA recommends that the Commission require California American Water to develop and include an infrastructure replacement strategy as part of its long-term capital asset management planning.⁸³ These requirements are more rigorous than the current regulatory process. Because the Commission approves the level of expenditure, not the underlying projects, California American Water currently has the ability to reprioritize or add projects and to shift funding between projects without submitting supporting documentation. Additionally, unlike the ISRS program, California American Water can begin recovering the costs of these projects in

⁸³ DRA references pages 56 and 57 of the Proposed Decision in A.06-01-005 (California American Water's General Rate Case for its Los Angeles District). Although the Proposed Decision would require the review of the plans and underlying detailed cost estimates in a general rate case prior to commencing construction projects, it is unclear that DRA proposed to adopt the pre-approval requirement under consideration in this proceeding.

rates even before they are completed. While a showing of a long-term capital asset management plan may be necessary at some point, it should not be required until an ISRS program is in place and it is clear that the results of the program are beneficial.

b. Imposition of the Tier 3 Advice Letter Process Removes the Administrative Efficiencies Created by the ISRS Program.

DRA asserts that the Commission should adopt a Tier 3 Advice Letter procedure, which would not provide the expedited review and approval in California American Water's original ISRS proposal, but rather would include notice to all interested parties, a full protest period, and a formal Commission resolution for adoption. DRA's modifications have the potential to delay implementation of ISRS surcharges for expenditures until long after the replacement property is already providing improved service to the customers. Since the Commission already allows rates to be implemented for forward-looking capital expenditures as well as construction work that is still in progress, delaying the implementation of surcharges to recover additional capital costs for construction projects that are actually completed and placed in service is actually a step backward in California regulation.

If the Commission believes that additional oversight requires a more robust review than provided in California American Water's original ISRS program, California American Water proposes that the Commission adopt a process to implement "interim" ISRS surcharges within 15 days of filing the advice letters. The parties could then continue with the review process and make adjustments to subsequent ISRS surcharges as needed. If the Commission does not reject DRA's modification, it will doom the ISRS program to failure before it starts.

C. Special Request #3 –Consolidation of Sacramento and Larkfield Districts for Ratemaking Purposes.

The Commission should adopt California American Water's proposal to combine the revenue requirements of the Sacramento and Larkfield Districts for ratemaking purposes because it is demonstrably in the public interest. As a matter of Commission policy,

consolidating the Sacramento and Larkfield rates will most efficiently and fairly share costs among customers in the two districts. As discussed below, combining the revenue requirements of each district to form a single revenue requirement (1) will benefit all customers by achieving long-term benefits and savings for customers and promoting the long-term affordability of water service; and (2) is supported by the recommendations in the Commission's Water Action Plan, statutory law and Commission precedent.

Despite the significant evidence that the proposed rate consolidation will achieve long-term benefits and savings for customers, both DRA and MWACSC oppose the proposed consolidation because California American Water's rate consolidation proposal does not meet the requirements of the "Guidelines for Combining of Water Utility Districts Ratemaking and Public Utilities Commission Reporting Purposes," issued in 1992, ("DRA Guidelines"). As explained below, the fact that the proposed rate consolidation does not meet some of the requirements of the DRA Guidelines is irrelevant here because the rate consolidation proposal is demonstrably in the public interest.

MWACSC's representatives continue to argue that California American Water's rate consolidation proposal is quasi-legislative and thus inappropriate for this proceeding even though MWACSC's failed argument has been repeatedly addressed and rejected in this proceeding. As MWACSC is well aware, the Assigned Commissioner and Administrative Law Judge have ruled that consolidation is properly within the scope of the proceeding.⁸⁴ Apparently, MWACSC refuses to believe that special requests such as the consolidation proposal are wholly appropriate for consideration in this general rate case because they will only be applicable to California American Water and are not intended to apply to the water industry at large.

MWACSC argues that because a decision approving consolidation could be cited as precedent it is quasi-legislative and therefore California American Water's rate consolidation

⁸⁴ *Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge*, dated April 11, 2007, pp. 3-4.

request must be considered in a rulemaking rather than in this case.⁸⁵ California American Water has repeatedly explained to MWACSC that even though the ratemaking treatment of California American Water's consolidation request could inform cases for other water utilities down the road, the requested relief is not a regulation applicable to all Commission-regulated water utilities. The rate consolidation proposal is a special request that would apply only to California American Water and would not apply to other water utilities, and therefore is appropriate for consideration in this general rate case.⁸⁶

1. California American Water's Rate Consolidation Proposal Will Benefit All Customers in the Larkfield and Sacramento Districts.

As set forth in California American Water's Opening Brief, California American Water's proposal to consolidate rates in the Sacramento and Larkfield Districts will serve the larger goals of rate equalization and water affordability for all customers. California American Water has demonstrated that consolidating the Larkfield District with a larger district for ratemaking purposes will reduce the impact to customers in a high cost area by spreading the costs of operation, maintenance and administrative costs over a larger customers base. Beyond merely asserting that the rate consolidation proposal would result in increased rates for customers in the Sacramento District, DRA has done nothing to demonstrate that the end result of consolidating rates in the Sacramento and Larkfield Districts is unfair. DRA's reasoning that any increase in rates would unfairly discriminate against Sacramento customers, even if Sacramento customers' rates are low in comparison to the Larkfield customers' rates, is flawed.

DRA's contention that consolidation should be rejected because it unfairly discriminates against Sacramento customers is contradicted by the evidence in this proceeding.⁸⁷

⁸⁵ Opening Brief of the Mark West Area Community Services Committee ("MWACSC Opening Brief"), p. 3.

⁸⁶ See Exh. 23, Stephenson Rebuttal, p. 33:24-34:3, citing California American Water's Prehearing Conference Statement, filed March 22, 2007.

⁸⁷ DRA Opening Brief, p. 40.

As explained in California American Water's Opening Brief, under the rate consolidation proposal, each customer in the Larkfield District currently pays higher rates than those in the Sacramento District for the same distribution service. The two districts are operated under the same general management structure and therefore the normal operating costs for each district should be approximately the same on a per customer basis.⁸⁸ Combining the revenue requirements would equalize the rates paid by the customers in the two districts. Thus, as a matter of fairness, the Commission should adopt California American Water's proposal to consolidate the rates for the Sacramento and Larkfield Districts.

DRA's contention that the Commission should rely on a low-income program such as Low Income Ratepayer Assistance (LIRA) in place of its rate consolidation proposal ignores the fact that spreading the cost of service over a combined Sacramento-Larkfield customer base will achieve long-term water affordability for all customers.⁸⁹ Whereas a low-income program will only benefit those eligible customers who seek assistance, spreading the revenue requirement over the combined customer base to form a single revenue requirement will benefit all customers in the Sacramento and Larkfield Districts by stabilizing rates and promoting water affordability in the long-term.

DRA's contention that the rate consolidation proposal will burden low-income customers in the Sacramento District is unsupported by the record.⁹⁰ DRA cites to 2000 Census data for the proposition that the poverty level for California American Water's customers in the Sacramento District is higher than the poverty level of its customers in the Larkfield District even though Mr. Stephenson testified that the Census data did not accurately reflect California

⁸⁸ CAW Opening Brief, p. 31. The Sacramento District is a "larger" district primarily because a number of small systems within Sacramento County were consolidated into a single ratemaking district.

⁸⁹ DRA Opening Brief, p. 40.

⁹⁰ DRA Opening Brief, p. 37.

American Water's service territory for the Sacramento and Larkfield Districts.⁹¹ Without any supporting evidence, DRA further argues that consolidation will increase the burden on California American Water's customers in Sacramento over the long-term.⁹² DRA's conclusions that rate consolidation will allegedly burden California American Water's low-income customers are simply unsubstantiated.⁹³

While DRA agrees that customers in the Larkfield District will benefit from the proposed rate consolidation, it claims that "[t]he people **who would benefit from consolidation** in this GRC are largely against it."⁹⁴ The limited group of Larkfield customers opposing the proposed consolidation is comprised of a small fraction of the customers in the Larkfield District.

In a desperate attempt to show that customers in both districts oppose the proposed consolidation, DRA mischaracterizes the testimony of California American Water regarding California American Water's public outreach efforts in Larkfield as "aggressive."⁹⁵ Contrary to DRA's claims, California American Water made reasonable and appropriate outreach efforts regarding the proposed consolidation to all of its customers in both the Sacramento and Larkfield Districts.⁹⁶ DRA's only evidence that Sacramento customers oppose

⁹¹ RT 151:16-24 (Stephenson/CAW) (testifying that the zip code covered by the Census Bureau included a far greater area than just the Larkfield District service territory); 152:4-14 (testifying that the Sacramento District includes only portions of Sacramento County and that the service territory for Sacramento District includes Placer County).

⁹² DRA Opening Brief, p. 37.

⁹³ California American Water also notes that qualifying incomes for the Commission's low-income program are different from the "poverty line."

⁹⁴ DRA Opening Brief, p. 42 (emphasis added).

⁹⁵ DRA Opening Brief, pp. 41-42.

⁹⁶ See RT 429:13-27 (Glover/CAW) (testifying that California American Water held two public participation hearings in Sacramento, held additional community meetings in Sacramento, and ran a series of advertisements in the Sacramento Bee to notify customers of the community meetings. In addition, California American Water mailed notices to all of its Sacramento customers regarding the consolidation on two occasions and sent direct mailers regarding the

(continued...)

the proposed consolidation is the few customers who attended the two Public Participation Hearings held in Sacramento and only a handful of emails, hardly representative of the 57,000 customers in the Sacramento District.

2. The Water Action Plan, Statutory Law, and Commission Precedent Support California American Water's Rate Consolidation Proposal.

The rate consolidation proposal is supported by the important recommendations in the Commission's Water Action Plan to make water affordable for customers in the long-term and reduce the impact in small, single districts of operation, maintenance and administrative costs; the important goals of water affordability and long-term rate stabilization identified by the California Legislature; and Commission precedent supporting rate consolidation when the benefits (lower rates for customers in higher cost areas) exceed the costs (higher rates for customers in lower cost areas); less efficient allocation of water resources).⁹⁷

a. The Water Action Plan.

Importantly, California American Water's rate consolidation proposal is supported by the Commission's Water Action Plan, which specifically identifies rate consolidation as a potential solution to achieving the long-term affordability of water service in the face of the escalating infrastructure and operational costs.⁹⁸ Objective 6 of the Water Action Plan recognizes that the Commission has previously adopted policies subsidizing customers through regionalization, consolidation of rates, and "postage stamp rates" and that such cross-subsidization "may work for large, multi-district water companies where there are a large number of customers."⁹⁹ Additionally, Objective 5 of the Water Action Plan notes the

(continued...)

consolidation to key customers and representatives in the area, including mayors and supervisors.).

⁹⁷ D.00-06-075, *35.

⁹⁸ Water Action Plan, pp. 21-22.

⁹⁹ Water Action Plan, pp. 20-21.

importance of reducing the impact in small, single districts of operation, maintenance and administrative costs by facilitating the acquisition of small water systems by Class A investor-owned water utilities.¹⁰⁰ The Commission has recognized that providing incentives for water utilities to acquire smaller systems (such as through rate consolidation) will prevent certain areas from suffering from poor water quality water or going without water service altogether.

Although DRA argues that the Water Action Plan is only a guideline, it agrees that the Water Action Plan identifies potential solutions for major policies concerning the regulation of investor owned water utilities and that the Water Action Plan calls for the Commission to adopt policies that will subsidize high cost areas through the consolidation of districts or rates.¹⁰¹ DRA's argument that the rate consolidation proposal is not justified by the Water Action Plan is thus, without merit.

b. California Public Utilities Code Section 701.10

Similarly, the rate consolidation proposal helps the Commission accomplish the important goals of water affordability and long-term rate stabilization identified by the California Legislature. Section 701.10 (b) of the California Public Utilities Code provides that water utility rates shall "[m]inimize the long-term cost of reliable water service to water customers," and Section 701.10 (e) provides that water utility rates shall "promote the long-term stabilization of rates in order to avoid steep increases in rates."¹⁰² The Commission should find that Section 701.10 supports rate consolidation.

¹⁰⁰ Water Action Plan, p. 7; *See* Cal. Pub. Util. Code, §§2718, 2719, 2720 (added by the Public Water System Investment and Consolidation Act of 1997 to provide incentives to promote company acquisitions of small private water utilities).

¹⁰¹ DRA Opening Brief, pp. 28, 40.

¹⁰² Unless otherwise stated, all statutory references are the California Public Utilities Code. Cal. Pub. Util. Code, §701.10 provides that:

The policy of the State of California is that rates and charges established by the commission for water service provided by water corporations shall do all of the following:

(continued...)

DRA contends that the rate consolidation proposal “fails to adhere to the Commission’s cost of service principle as required in Section 701.10” because the statute “requires that the rates and charges established by the Commission for water service shall be based on the cost of providing the water service.”¹⁰³ Section 701.10 nowhere requires that each customer or each customer group pay only the costs it causes to be incurred. Moreover, the rigid application of the “cost of service” principle proposed by DRA would unfairly subject the Larkfield customers to significantly higher costs per customer simply because of the size of the district and a smaller customer base. Additionally, DRA favors conservation rate structures. Conservation rate structures are intended to reduce consumption by placing more of the revenue requirement recovery of larger use customers. Conservation rates are definitely not based on the cost of service, so DRA appears to be recommending strict adherence to cost of service in one instance and against it in other instances.

As explained in California American Water’s Opening Brief, the proposal to combine the revenue requirements for the Sacramento and Larkfield Districts is compatible with cost-of-service ratemaking.¹⁰⁴ DRA and MWACSC appear to misunderstand that the revenue requirements for both districts will be rolled into a common revenue requirement for purposes of

(continued...)

(a) Provide revenues and earnings sufficient to afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility.

(b) **Minimize the long-term cost of reliable water service to water customers.**

(c) Provide appropriate incentives to water utilities and customers for conservation of water resources.

(d) Provide for equity between present and future users of water service.

(e) **Promote the long-term stabilization of rates in order to avoid steep increases in rates.**

(f) Be based on the cost of providing the water service including, to the extent consistent with the above policies, appropriate coverage of fixed costs with fixed revenues.

(emphasis added to original.)

¹⁰³ DRA Opening Brief, p. 35.

¹⁰⁴ CAW Opening Brief, pp. 32-33.

setting rates and the combined cost of service for the Sacramento and Larkfield Districts will then be allocated to customers in both districts. In addition to the fact that the Commission itself has recognized that “single-tariff pricing” is a ratemaking tool compatible with traditional cost-of-service ratemaking,¹⁰⁵ DRA has failed to show that the proposed consolidation would eliminate pricing incentives that cannot be addressed through rate design.¹⁰⁶

c. Prior Commission Decisions.

Prior Commission decisions support California American Water’s rate consolidation proposal. In D.00-06-075, the Commission approved Southern California Water Company’s (SCWC) rate consolidation of eight of its water districts based upon the need for rate relief in some of the districts.¹⁰⁷ DRA mistakenly argues that D.00-06-075 is distinguishable from this case and that California American Water has not demonstrated that Larkfield District is an “impoverished district.”¹⁰⁸ While California American Water did provide evidence that rate relief is needed, nowhere in D.00-06-075 (or other decisions) did the Commission state that poverty or the “need” for rate relief is the determining factor in approving proposals for rate consolidation. Rather, the Commission approved the rate consolidation proposal in D.00-06-075 because SCWC had demonstrated that rate consolidation would “benefit existing and future customers [in the affected districts] by stabilizing rates, making rates more affordable in the smaller districts, and facilitating investment in water supply infrastructure and water treatment

¹⁰⁵ D.00-06-075, *Application of the Southern California Water Company (U 133 W) for authority pursuant to Public Utilities Code Section 454 to restructure the water rates of its Barstow, Calipatria-Niland, Claremont, Desert, Orange County, San Dimas, San Gabriel and Wrightwood Districts into region-wide tariffs*, (“D.00-06-075”) 2000 Cal. PUC LEXIS 1114**45, 51-52, Conclusion of Law ¶4.

¹⁰⁶ CAW Opening Brief, pp. 32-33.

¹⁰⁷ D.00-06-075 **1-2.

¹⁰⁸ DRA Opening Brief, p. 38.

facilities.”¹⁰⁹ California American Water has shown that the substantial benefits of consolidation would far exceed the costs.

Despite DRA’s and MWACSC’s emphasis on the DRA Guidelines, the Commission noted in D.00-06-075 that the Ratepayer Representation Branch’s reliance on the DRA Guidelines was misplaced and that the Guidelines “implicitly permit proposals for broader rate consolidations.”¹¹⁰ The Commission has held that a prima facie demonstration of compliance with the DRA Guidelines is not necessary to find that rate consolidation is in the public interest. Accordingly, DRA’s reliance upon the DRA Guidelines in this case is misplaced.

DRA’s contention that the consolidation proposal is a “pure subsidy” that is contrary to Commission practice is false and misleading.¹¹¹ First, while the sole purpose of the proposed consolidation is not for one district to subsidize another, California American Water is not proposing something contrary to Commission practice when it proposes to combine the revenue requirements of the two districts for ratemaking purposes. Second, California American Water’s rate consolidation proposal here is based upon three recent Commission-approved settlement agreements authorizing the consolidation of districts for ratemaking purposes.¹¹²

¹⁰⁹ D.00-06-075 *51, Conclusion of Law ¶1.

¹¹⁰ D.00-06-075, *41.

¹¹¹ DRA Opening Brief, p. 33.

¹¹² See CAW Opening Brief, pp. 37-38 for a description of three recent Commission-approved settlement agreements authorizing the consolidation of districts for ratemaking purposes. See D.93-01-006, *Application of Suburban Water Systems (U 339-W) for an order authorizing it to combine its present separate Whittier and La Mirada Districts into a single Whittier/La Mirada District, and to increase its rates for water service in its newly formed Whittier/La Mirada District*, 47 CPUC.2d 568, 1993 Cal. PUC LEXIS 6 (approving the consolidation of Suburban Water System’s (Suburban) Whittier and La Mirada Districts into a single Whittier/La Mirada District); D.94-11-004, *Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Duarte District; In the Matter of the Application of California American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Baldwin Hills District; In the Matter of the Application of California American Water (U 210 W) for an order authorizing it to increase its rates for water service in its San Marino District*, 57 CPUC.2d 127, 1994 Cal. PUC LEXIS 1093

(continued...)

California American Water's proposal to consolidate the rate structures of the Sacramento and Larkfield Districts is nothing new from what the Commission has authorized in other districts.

3. In the Event the Commission Determines that Full Rate Consolidation is Not Justifiable, It Should Then Consider Partial Consolidation or Other Alternatives.

DRA concedes that California American Water's alternative consolidation proposal of holding the rates in Larkfield constant until they are approximately equal to those for metered customers and then shifting the under-recovered portion of the proposed revenue requirement to Sacramento will reduce the impact on Sacramento customers. DRA also recognizes that its concerns with full rate consolidation apply to a lesser degree with California American Water's partial rate consolidation.¹¹³ Accordingly, if the Commission determines that full rate consolidation of the Sacramento and Larkfield Districts is not justifiable, the Commission should consider the alternatives proposed by California American Water to achieve lower rates in the long-term for customers in the Larkfield District.

Although DRA claims that consolidation is only one method of achieving affordability, DRA fails to provide evidence of an alternative to the rate consolidation proposal that will promote long-term affordability of water service for all customers.

D. Administrative and General ("A & G") Expenses

The analysis DRA claims support a reduction to California American Water's Employee Pension and Benefits expenses and Regulatory Expenses is meaningless. DRA's

(continued...)

(authorizing the consolidation of California American Water's Baldwin Hills, Duarte and San Marino Districts into a single district for ratemaking purposes); D.96-04-076, *Application of Suburban Water Systems (U 339-W) for an order authorizing it to combine its present separate San Jose Hills and Whittier/La Mirada Districts into a single district encompassing total company operations, and to increase its rates for water service for the total company*, 66 CPUC.2d 59, 1996 Cal. PUC LEXIS 613 (approving the consolidation of Suburban's San Jose Hills and Whittier/La Mirada Districts into a single district).

¹¹³ DRA Opening Brief, p. 43.

proposed reductions to California American Water's Employee Pension and Benefits expenses and Regulatory Expenses are not supported by the evidence and demonstrate a lack of understanding of what California American Water has requested in this rate case. California American Water has demonstrated that its Employee Pension and Benefits expenses and Regulatory Expenses are the most accurate estimates of future costs. As such, the Commission should reject DRA's proposed reductions so that California American Water is not denied the opportunity to recover all of its prudent expenses.

1. Employee Pension and Benefits

The Commission should reject DRA's proposed reductions to Employee Pensions and Benefits expenses because they are based upon unreliable and faulty analysis. A large portion of DRA's proposed reductions to the Employee Pension and Benefits expenses for the four Districts are the result of the inappropriately low escalation factor utilized by DRA to calculate Group Insurance.¹¹⁴ However, only a small portion of California American Water's proposed expenses were actually derived by escalating historical costs. As discussed below, California American Water utilized actual trend analysis for its allowances for group insurance, and actuarial projections for pensions and post-retirement benefits other than pensions (OPEB). These items comprise a large portion of the total Employee Pension and Benefits expenses. DRA's analysis fails to take into account that the majority of California American Water's Employee Pension and Benefits are based upon actual projections that more accurately reflect future costs rather than an inadequately escalated historical average.

The Commission should reject DRA's proposed reductions for the following reasons, (a) DRA's proposed estimates fail to take into consideration the actual projections by

¹¹⁴ While the low escalation factor utilized by DRA is the primary reason for DRA's proposed reductions in the Coronado and Village Districts, DRA incorrectly states that it is the only reason. DRA Opening Brief, p. 43 (discussing Sacramento District); p. 44 (discussing Larkfield District); p. 45 (discussing Coronado District); p. 46 (discussing Village District).

actuarial reports and actual pension costs and therefore significantly understate these expected pensions and OPEB's expenses; (b) the inflation factor utilized by DRA for Group Insurance is arbitrary and totally out of line with the annual increase of California American Water's actual costs; (c) there is simply no justification for DRA to deviate from the historical five-year average utilized by California American Water to forecast Employee Pension and Benefits (other than group insurance, pension and OPEB expenses); and (d) California American Water has demonstrated that the benefits of its employee awards flow through to customers and therefore should be allowed.

a. Actual trend analysis for Pensions and OPEB's expense allocations.

DRA, in its brief, incorrectly states that California American Water calculated all of its Employee Pension and Benefits expenses by applying an escalation factor to a historical average.¹¹⁵ As such, DRA's brief does not take into account that California American Water's projections for the pensions and OPEB's are based upon actuarial projections. Given that DRA's analysis wrongly assumes that California American Water utilized an escalation factor, it is not credible.

Additionally, as set forth in California American Water's Opening Brief, these company-specific estimates are based upon the funding requirements provided by the actuarial firm of Towers and Perrin and are in accordance with the requirements of ERISA.¹¹⁶ It makes no sense to utilize an escalation factor, as DRA suggests, when actual costs or actual trend analyses are available.

¹¹⁵ See e.g., DRA Opening Brief, p. 43 (stating that California American Water's estimate of Sacramento Employee Pension and Benefits is based on a five-year average of years 2002 to 2006 escalated to 2007, then escalated to Test Year 2008).

¹¹⁶ Exh. 10, Direct Testimony of Stacey Fulter in the Village District ("Village Fulter Direct"), p. 6; Exh. 12, Direct Testimony of Stacey Fulter in the Coronado District ("Coronado Fulter Direct"), p. 6.

Furthermore, California American Water provided evidence in its March 8, 2007 update to its Applications demonstrating that it has underestimated its pensions and OPEB's projections.¹¹⁷ Even accepting the full Employee Pension and Benefits expenses proposed by California American Water will still lead to under recovery.

b. DRA's incorrect escalation rate for health care insurance premium costs.

DRA arbitrarily applies an escalation rate of Consumer Price Index for all Urban Consumers (CPI-U) for the Sacramento and Larkfield Districts and Energy Cost of Service Branch (ECOS) for the Village and Coronado Districts. In using these escalation factors, DRA utterly fails to account for these increasing health care costs. In contrast, California American Water's estimates for group insurance are based upon its actual 2006 expenditures, inflated for its actual average increase percentage. California American Water's yearly increase in premium costs for health insurance (inflation factor of 8 percent for 2007 and 9 percent for test year 2008) was provided by California American Water's parent company, and as provided by its health insurance carrier, and is based upon a number of factors, including the increasing trend in health care costs.¹¹⁸ California American Water provided evidence that health care costs, as with other companies in California and throughout the United States are in the very high single digits and will continue rising into the foreseeable future.¹¹⁹ In its Brief, DRA recognizes that California American Water's escalation factors of eight and nine percent reflect the increasing historical trend in health care premium costs.¹²⁰

¹¹⁷ California American Water received revised actuarial estimates for test year pension costs under ERISA that were higher by \$86,500 than what was provided in the application. Exh. 18, Rebuttal Testimony of Rodney L. Jordan ("Jordan Rebuttal"), pp. 8:21-25.

¹¹⁸ Exh. 10, Village Fulter Direct, pp. 5-6; Exh. 12, Coronado Fulter Direct, pp. 5-6.

¹¹⁹ See CAW Opening Brief, p. 43.

¹²⁰ DRA Opening Brief, p. 43 (discussing Sacramento District); p. 44 (discussing Larkfield District); p. 45 (discussing Coronado District); p. 46 (discussing Village District).

DRA's Brief fails to take into account evidence that the CPI-U factor and the ECOS factor utilized by DRA are well below the increase of health care costs.¹²¹ DRA's Brief simply restates that DRA utilized the CPI-U factor and the ECOS factor even though DRA's own witness agreed that DRA erred in using the CPI-U to estimate group insurance expenses.¹²² DRA's witness also agreed that California American Water's escalation factors of eight and nine percent to forecast group insurance estimates more accurately reflect the historical increases.¹²³ Without explaining why California American Water should be denied the opportunity to recover all of its prudent expenses, DRA requests that the Commission adopt its estimates for Employee Pension and Benefits, which significantly reduce the allowance for group insurance. Without such an explanation or justification, the Commission must reject DRA's proposed reductions.

Finally, DRA's analysis is based upon the incorrect assumption that health care insurance premiums are categorized as insurance for purposes of escalating the test year, and therefore linked to the CPI-U and ECOS. These expenses are categorized as pension and benefits under the Commission's Uniform System of Accounts, and therefore should have been linked to the Labor factor.¹²⁴ Indeed, D.04-06-018¹²⁵ provides that the escalation rate for pension and benefit expenses, including group health insurance, should be linked to the Labor factor and not the CPI-U and ECOS.

¹²¹ See CAW Opening Brief, p. 44 (discussing DRA's use of the CPI-U factor).

¹²² RT 406:25-26 (Greene/DRA).

¹²³ RT 406:19-21 (Greene/DRA) (agreeing that escalation rates of 8 percent and 9 percent are "closer to their historical increases.").

¹²⁴ CAW Opening Brief, pp. 44-45.

¹²⁵ D.04-06-018, *Parties Of Record In Rulemaking 03-09-005; Order Instituting Rulemaking On The Commission's Own Motion To Evaluate Existing Practices And Policies For Processing General Rate Cases And To Revise The General Rate Case Plan For Class A Water Companies*, 2004 Cal. PUC LEXIS 276.

c. Historical five-year average for Employee and Pension and Benefits expenses (not including group insurance, pension and OPEB).

There is simply no reason to deviate from the historical five-year average utilized by California American Water to forecast estimated future Employee and Pension and Benefits expenses (not including group insurance, pension and OPEB). DRA claims that California American Water did not provide adequate explanation of the expense recorded in 2002 for the Sacramento District and did not include the breakdown of recorded data in 2002 for the Larkfield District.¹²⁶ This is simply untrue. California American Water provided the same documentation in its workpapers in 2002 as it did for each of the years utilized in its five-year forecast (2002 to 2006). The Commission should not adopt DRA's omission of 2002 data simply because recorded expenses were higher that year due to normal variation.¹²⁷

d. Employee awards.

DRA contends that California American Water's employee awards are "not necessary to operate the utility" and proposes to disallow them from pension and benefit expenses.¹²⁸ Contrary to DRA's contention, these expenses serve a valid business purpose and the benefits of increased employee productivity and employee retention flow through to customers.¹²⁹ Because California American Water demonstrated that these expenses provide legitimate benefit to customers, DRA's disallowance should be ignored and California American Water's employee awards should be allowed.

¹²⁶ DRA Opening Brief, pp. 43, 44.

¹²⁷ CAW Opening Brief, p. 42.

¹²⁸ DRA Opening Brief, pp. 44-46.

¹²⁹ See Exh. 18, Jordan Rebuttal, p. 10:15-17 (explaining that employee awards and recognition serve a valid business purpose).

2. Regulatory Expenses

DRA first argues that the Commission should adopt its proposed reductions because California American Water's 2006 recorded Regulatory Expense, adjusted for inflation, will allegedly provide California American Water "with an adequate level of regulatory expenses."¹³⁰ Mr. Greene appeared to believe that the 2006 recorded amount for regulatory expense represented the actual expenditure by California American Water in 2006 for the Village and Coronado Districts.¹³¹ As California American Water explained in its Opening Brief, while it may have been DRA's intention to base its calculations upon the expenses incurred in 2006, DRA relied upon the settled allowances and not the actual amount incurred.¹³² DRA's reliance upon the settlement amounts agreed to by California American Water and DRA in the prior rate case is misplaced because such amounts do not reflect the actual expenses incurred to prepare, file and process the general rate case application. DRA's own witness agreed that DRA's methodology of adjusting these amounts for inflation may not be "100 percent defensible."¹³³

Additionally, in deriving its annual projected allowance in 2008, DRA took the adopted dollar amount for 2006 regulatory expense from the prior rate case, which was based upon the three-year recovery period in that rate case. DRA proposes that California American Water be authorized an annual expense, and then multiplies that amount by three. This is backwards from the normal regulatory expense procedure, which is to develop a total for regulatory expenses and then amortize that estimated amount over the three-year, or other appropriate rate case cycle.

¹³⁰ DRA Opening Brief, pp. 46-48.

¹³¹ RT 408:3-7 (Greene/DRA).

¹³² RT 407-408 (Greene/DRA) (Mr. Greene testified that he believed DRA's calculations were based upon the 2006 recorded expenses for California American Water). See also Exhibit 25, DRA Report, p. 4-6 (stating that "DRA used the adopted amount.").

¹³³ RT 410:25-26 (Greene/DRA).

DRA's contention that its proposed estimates are "adequate" is belied by evidence that California American Water's projected rate case expenditures have significantly increased since 2006 and that its Regulatory Expenses will be significantly higher than historical costs. These higher costs are the result of the significant costs of complying with the new Rate Case Plan adopted in D.04-06-018, the bifurcation of this proceeding, and the fact that direct labor charges are now charged to the individual districts rather than California American Water's general office costs.

DRA acknowledges that "there will be considerable regulatory expenses in preparation for and during a GRC proceeding," yet claims that California American Water's Regulatory Expense in 2009 and 2010 "should be lower because Cal Am will not be preparing for and participating in a GRC."¹³⁴ The fact that the Commission will approve a total dollar amount for regulatory expenses that will be amortized over the recovery period should come as no surprise to DRA. DRA's contention that an annual projected allowance is reasonable because "the amount for regulatory expenses is amortized over three years" is circular reasoning and has no bearing on the amount of regulatory expenses that should be included in the revenue requirement. The April 2007 cost data demonstrates that California American Water has already exceeded DRA's estimate for regulatory expense (using a standard three-year amortization period) and that significant expense has been and will be incurred since that time.¹³⁵

Utilizing the annual projected allowance proposed by DRA will be problematic in light of the newly adopted Rate Case Plan. As a result of the newly adopted Rate Case Plan, the projected regulatory expense for the Sacramento and Larkfield Districts, which comprise a larger portion of these total expenses, will need to be recovered over only a two-year period, and the projected expenses for the Coronado and Village Districts, which comprise a smaller portion of

¹³⁴ DRA Opening Brief, p. 46 (discussing Sacramento District); p. 47 (discussing Larkfield District); p. 48 (discussing Coronado District); p. 48 (discussing Village District).

¹³⁵ CAW Opening Brief, p. 52.

these total expenses, will need to be recovered over a four-year period.¹³⁶ Thus, DRA's proposed allowance will further reduce the amount to be recovered by California American Water for regulatory expense in this rate case.

DRA's proposed reductions to California American Water's projected regulatory expense must be rejected because they will deny California American Water the opportunity to recover its prudent rate case expenditures. As set forth in California American Water's Opening Brief, DRA ignored evidence that its proposed amounts are highly unrealistic, as demonstrated by California American Water's actual regulatory expenses incurred through April 2007 for regulatory expenses for each of the four districts.¹³⁷ While it was not known at the time California American Water filed its application that the proceeding would be bifurcated, as a result of the bifurcation of the proceeding, California American Water (and DRA) significantly underestimated the regulatory expense.¹³⁸ The proceeding was bifurcated at DRA's request, and as a result, DRA is increasing the expense of litigating this case, but is not allowing California American Water the opportunity to recover such increased expenses.

III. MARK WEST AREA COMMUNITY SERVICES COMMITTEE'S CONTENTIONS REGARDING THE LARKFIELD DISTRICT

In the sections below, California American Water responds to the contentions of MWACSC on the following issues: (A) the existing water supply deficit in the Larkfield

¹³⁶ The newly adopted Rate Case Plan will require California American Water to: (1) again file its general rate case for Larkfield and Sacramento Districts in 2008, with the current case limited to a test year and escalation year (no attrition year); and (2) add a second attrition year to its current Coronado and Village Districts. *D.07-05-062, Opinion Adopting Revised Rate Case Plan For Class A Water Utilities, (May 24, 2007).*

¹³⁷ Exh. 27, DRA Report on the Results of Operation in Village District of California-American Water Company, p. 4-4:22-23; RT 407:15-18 (Greene/DRA) (testifying that the recorded expense should be used); Exh. 18, Jordan Rebuttal, pp. 24:27-25:12.

¹³⁸ DRA acknowledged that a bifurcated proceeding, which involves two sets of testimony and two sets of hearings, could result in increased regulatory expenses. *See* RT 413:10-13 (Greene/DRA).

District; (B) the effect of conservation on the water supply deficit in the Larkfield District; and (C) utility plant in service, including the Faught Road Well, the related Water Treatment Plant Improvements, and the North Wikiup Tank.

As a general matter, MWACSC's opening brief suffers from widespread mischaracterizations of California American Water's request in this case, misconstrues testimony and improperly attempts to introduce new information that is not part of the evidentiary record, and grossly misstates the Commission's ratemaking practices. MWACSC's document is comprised of opinions rather than fact, speculation and conjecture and, as such, is unreliable and should be disregarded in its entirety. California American Water files concurrently herewith a Motion to Strike MWACSC's Brief because it introduces new information that is not part of the record, inappropriately discloses information obtained through confidential settlement negotiations, and makes egregious and offensive statements that are not supported by the record.

A. Larkfield District Water Supply.

MWACSC's Opening Brief, under the heading "Larkfield District Water Supply" and sub-heading "Examining the Analysis for the Year 2010," recites a series of speculations as to how California American Water's Operations Plan, prepared in 2004 by Bookman-Edmonston ("Operations Plan") might be modified to reach the result desired by MWACSC. MWACSC also introduces numerous "recalculations" to California American Water's General Order 103 analyses. The value of these self-serving comments is highly questionable given that MWACSC's witness is a non-expert with no experience in water supply planning and hydro geological conditions.

Furthermore, MWACSC's speculative comments are raised for the first time in this proceeding, are not supported by the record, are procedurally improper and confuse the record, and should not be tolerated by this Commission. Despite MWACSC's poorly crafted arguments, discussed below, MWACSC fails to refute that there is an existing deficit in the water supply needs of the Larkfield District and that an additional well supply is prudent in order

to ensure an adequate, reliable and dependable source of supply is maintained for the Larkfield District customers.

1. The 2004 Operations Plan: Existing pumping restrictions on the Larkfield District wells.

Without any explanation, MWACSC contends that the well capacity data submitted by California American Water to Department of Health Services (DHS) shows that the pumping capacity restrictions set forth in the 2004 Operations Plan are unnecessary.¹³⁹ This is simply untrue and is unsupported by the record. MWACSC chooses to ignore the testimony of Mr. Thomas Glover, General Manager for California American Water's Northern Division, that the data submitted to DHS is the rated capacity for California American Water's four individual wells whereas California American Water's 2004 Operations Plan reflects the reduced well production caused by well interference.¹⁴⁰ As explained in California American Water's Opening Brief, the 2004 Operations Plan limits the pumping and production capacity of the wells to ensure an adequate and sustained safe yield of pumping from these wells.¹⁴¹ Because the existing Larkfield wells are close enough in proximity to each other to cause well interference, significant increased pumping rates and duration will have an overall impact on all the wells' pumping capability because of the additional drawdown occurring in the wells.¹⁴² The consultant who prepared the 2004 Operations Plan recognized the overlapping occurring between the respective wells and recommended an appropriate pumping plan for the winter and summer seasons to ensure that the Larkfield District's wells are operated and utilized in an efficient manner.

¹³⁹ MWACSC Opening Brief, p. 7.

¹⁴⁰ RT 456:19-28 (Glover/CAW).

¹⁴¹ CAW Opening Brief, p. 55. *See also* RT 455:25-28 (Glover/CAW) (testifying that "to reliably operate these wells, we have developed this Operations Plan so we could have a sustainable water source to treat to supply to our customers in Larkfield District.").

¹⁴² Exh. 17, Glover Rebuttal, p. 8:12-14.

In its Opening Brief, MWACSC creates completely speculative methods to increase the Larkfield water supply by increasing the pumping rate of California American Water's wells. MWACSC absurdly contends that the limitations on well pumping and production capacity in the Operations Plan are unnecessary and the pumping can be increased by approximately 100 gallons per minute to eliminate the need for a new well. To address any deficits that occur on peak days, MWACSC asserts that California American Water can cover the deficit with modified pumping capacity for peak days only.¹⁴³ MWACSC speculates that California American Water could increase the pumping rate 100 gallons per minute without adversely affecting the pumps, wells and the aquifer.¹⁴⁴ No reasonable reading of Mr. Glover's (or any other witness) testimony can support the assertions by MWACSC that California American Water can increase the pumping capacity and thereby eliminate the need for a new well. In fact, Mr. Glover testified that "the recommended pumping capacities of the wells are necessary to ensure an adequate and sustained safe yield of pumping from these wells."¹⁴⁵

2. California American Water Has Demonstrated Through Multiple Analyses that There is an Existing Deficit in the Larkfield District Water Supply Needs.

The record contains comprehensive and detailed evidence that there is already an existing deficit in the water supply needs of the Larkfield District. California American Water conducted multiple analyses, including the analyses required under the Commission's General Order 103, which shows that there is a current deficit of 206 gallons per minute in the Larkfield District.¹⁴⁶ The industry standard water supply analysis, known as Reliable Pumping Capacity,

¹⁴³ MWACSC Opening Brief, p. 8.

¹⁴⁴ MWACSC Opening Brief, p. 9.

¹⁴⁵ Exh. 17, Glover Rebuttal, p. 8:26-27.

¹⁴⁶ See CAW Opening Brief, pp. 56-57 for an explanation of the General Order 103 analyses. Versions 1 and 2 of the General Order 103 "Analysis of Water Supply (Scenario A)" demonstrate that there is a current deficit of 206 gallon per minute in the Larkfield District. Version 1 of the General Order 103 analysis shows an estimated deficit of 418 gallons per

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also demonstrates that an additional well supply is prudent in order to ensure an adequate, reliable and dependable source of supply is maintained for the Larkfield District customers.¹⁴⁷ Finally, a report prepared by Coastland Civil Engineering, Inc. for the Sonoma County Water Agency and included as an attachment to MWACSC's comments confirms that there is a deficit and that an additional well supply should be added before 2010.¹⁴⁸

Although MWACSC failed to perform its own General Order 103 analyses of the Larkfield District water supply needs,¹⁴⁹ MWACSC attempts to now supplement the record with its own modifications to California American Water's General Order 103 analysis. Even though it never states what assumptions it used for its calculations, including whether its assumptions are consistent with the requirements of General Order 103, MWACSC claims that the number of customers used in the General Order 103 analyses are overstated. To that end, MWACSC attempts to modify the General Order 103 analyses to reflect a reduced customer base. However, it is clear throughout the General Order 103 analyses that California American Water shows an existing deficit based upon **2005 data**. Even with gross distortions of the record and manipulation of the data, MWACSC cannot change the fact that there is an existing water supply deficit in the Larkfield District.

If MWACSC was interested in analyzing the water supply under the requirements of General Order 103, it was free to do so. It did not do so. MWACSC's attempt to supplement the record now with recalculations of California American Water's General Order 103 analysis is

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minute in 2010, based upon current projects. These analyses assume pursuant to the requirements of General Order 103 the sustainable yield pumping rate for the groundwater sources, the value of four days of distribution storage and the average rate of water purchased by California American Water from Sonoma County Water Agency in any month.

¹⁴⁷ Exh. 17, Glover Rebuttal p. 26:4-6.

¹⁴⁸ RT 480:10-11; 22-24 (Glover/CAW).

¹⁴⁹ RT 523:19-23 (Bouler/MWACSC) (testifying that he performed no analysis on General Order 103).

wholly inappropriate, does nothing to address the real issue here, and should not be tolerated by this Commission.

MWACSC's self-serving analysis fails to take into consideration key evidence that California American Water's ability to meet existing and future water supply demands will be impacted by the curtailment of water available from the Sonoma County Water Agency. As explained in California American Water's Opening Brief, as a result of the reduction in water that can be purchased from Sonoma County Water Agency, additional water supply will be needed in order to operate a safe, reliable and adequate water supply for the Larkfield District customers.

Furthermore, MWACSC's contentions that the General Order 103 analyses do not take into consideration the water savings resulting from conservation efforts should be wholly disregarded.¹⁵⁰ The Commission should not abandon its well considered and long established analytical methods for projecting water supply demands set forth in General Order 103 in exchange for MWACSC's proposed approach of estimating the water savings that could be achieved through water conservation. As explained below in more detail, it would be imprudent for California American Water to rely upon estimates of water savings achieved through conservation in its water supply planning.

B. The Effect of Conservation on the Larkfield District Water Deficit.

The Commission should not countenance MWACSC's attempt to improperly introduce new information about conservation that is not part of the evidentiary record. As set forth in the motion filed concurrently herewith, MWACSC references both confidential information obtained through confidential settlement negotiations in this proceeding and information that is not part of the record. In an attempt to demonstrate that Larkfield customers can achieve water savings through conservation to address the existing and future water deficit,

¹⁵⁰ RT 523:19-27 (Bouler/MWACSC).

MWACSC repeatedly refers to the proposed settlement allowance for the implementation of the Urban Water Conservation Council's (UWCC) Best Management Practices (BMP), which is not part of the record. As noted above, it is highly inappropriate for MWACSC to attempt to introduce this information as part of the record when it can fully brief its position on the settlement of DRA and California American Water in comments and reply comments once the settlement is finalized. Notwithstanding, California American Water's allowance for conservation efforts in this rate case is irrelevant to the issue of whether water savings achieved through conservation can reduce the water supply deficit in the Larkfield District.

MWACSC's suggestion that conservation alone can be used to meet California American Water's existing and future water supply deficit is simply untrue. The fact of the matter is that any savings in water achieved through conservation will not likely reduce water supply needs during peak demand.¹⁵¹ California American Water has already demonstrated that there is an existing water supply deficit and it must develop water production sources to meet maximum period demands.

MWACSC's position that the Commission should not consider new sources of water until conservation methods have been "employed to the fullest extent" flies in the face of reason. While California American Water remains strongly committed to water conservation, MWACSC ignores the fact that California American Water cannot control customer consumption, without implementing rationing procedures. The savings related to conservation have more to do with the overall use and less to do with the total production needs for a maximum use short-term period.¹⁵² MWACSC's proposal suggests that California American Water has the option of refusing to provide service when its customers do not achieve water savings. As a utility regulated by this Commission, California American Water has an obligation

¹⁵¹ See Exh. 23, Stephenson Rebuttal, p. 45.

¹⁵² Exh. 23, Stephenson Rebuttal, p. 40:4-11.

to serve customers and cannot simply refuse to provide service. Contrary to MWACSC's misplaced belief, it would be imprudent and impossible for California American Water to rely on conservation for planning purposes, generally, and to address the existing deficit, specifically.¹⁵³

Mr. David Morse, a water conservation expert retained by California American Water, confirmed that estimates of the projected water savings should not be relied upon for water supply planning purposes because they are not reasonably accurate.¹⁵⁴ MWACSC recognizes that the estimated projected water savings are not completely reliable, yet insists that these estimates be included for planning purposes.¹⁵⁵ MWACSC's claim that California American Water should rely upon water savings estimates is not supported by credible evidence or analysis, and as such, should be disregarded. In any event, the fact remains that even with minor adjustments for conservation, the General Order 103 analysis demonstrates that there is still a significant deficit (206 gallons per minute) in the Larkfield District water supply needs.

In an unjustified attack against California American Water's commitment to water conservation, MWACSC argues that California American Water should be held accountable for failing to achieve conservation goals.¹⁵⁶ MWACSC's attempt to attribute bad faith to California American Water for the amount of water savings achieved through conservation is completely unfounded.

C. Utility Plant in Service

MWACSC contends that the Faught Road Well, the Larkfield Water Treatment Plant Improvements, and the North Wikiup Tank No. 2 are unwarranted, imprudent, unsafe and

¹⁵³ RT 507:1-4 (Glover/CAW).

¹⁵⁴ RT 420:24-421:27 (Morse/CAW).

¹⁵⁵ MWACSC Opening Brief, p. 10 (stating that "the estimates from the BMP calculations are reliable to some degree." (emphasis added to original)).

¹⁵⁶ MWACSC Opening Brief, pp. 9-10.

excessive are simply not supported by the record.¹⁵⁷ MWACSC, through its admittedly lay, non-expert witness who has no experience in designing or constructing water facilities,¹⁵⁸ attempts to second guess California American Water's business decisions concerning the design and construction of the North Wikiup Tank No. 2.

Even though the settlement agreement between DRA and California American Water will cover these very same projects, California American Water demonstrates below that the Faught Road Well, the Larkfield Water Treatment Plant Improvements, and the proposed design and construction costs for the North Wikiup Tank No. 2 are prudent and important investment projects. Contrary to MWACSC's misleading assertions, California American Water acted prudently in assuring that any risk associated with a seismic event at the North Wikiup Tank No. 2 was adequately defined and appropriately mitigated.

1. Faught Road Well Project.

MWACSC's opposition to the development of the Faught Road Well is based upon its erroneous assertions that: (1) California American Water has overestimated the current and projected water demands for the Larkfield District; and (2) California American Water has overestimated the pumping restrictions in the 2004 Operations Plan and that the Larkfield well pumping capacities can be increased based upon highly speculative calculations; and therefore the Faught Road Well is not needed to meet the existing water supply deficit.¹⁵⁹ In reaching its conclusion, MWACSC ignores overwhelming evidence that the Faught Road Well Project is critical to ensure the utility's continued ability to supply water to its existing customers based upon existing demand.

¹⁵⁷ See e.g., Exh. 23, Stephenson Rebuttal, pp. 42-46.

¹⁵⁸ RT 521-522 (Bouler/MWACSC).

¹⁵⁹ MWACSC Opening Brief, p. 12.

Without any justification, MWACSC asserts that the information provided by California American Water to DHS supports the conclusion that “any new wells are for the purpose of providing water for new growth.”¹⁶⁰ As discussed above, the data submitted to DHS is the **rated capacity** for California American Water’s four current wells, and does not reflect the actual well production. Contrary to MWACSC’s contention, the analyses provided by California American Water demonstrate that the Faught Road Well project is necessary to ensure that existing and future water supply demands are met, adequate production capacity and system reliability are maintained, and to reduce reliance upon the interruptible Sonoma County Water Agency Aqueduct interconnection. The Commission should find that the Faught Road Well is necessary to meet the existing water supply deficit and disregard MWACSC’s opposition to this investment project.

MWACSC also opposes the Faught Road Well because it believes that the costs of the project should be funded by developers. Because the purpose of the well is to serve existing customers to meet existing water supply demands, the project is appropriately recovered from customers.¹⁶¹ Here, MWACSC’s own witness agreed that “if a new well is needed to serve current customers, ... the well should be paid for by current customers.”¹⁶² MWACSC further argues that California American Water is attempting to circumvent the requirements of Rule 15 by having customers pay for new growth. Rule 15 sets forth the process water utilities must follow when working with developers, individual customers and others when they seek to expand the need of the system through additional water hook-ups. In this case, as in most cases for water supply and treatment, the proposed expansion of the Larkfield water treatment plant will benefit all customers, and therefore should be paid for by all customers. MWACSC’s

¹⁶⁰ MWACSC Opening Brief, p. 12.

¹⁶¹ Exh. 17, Glover Rebuttal, p. 6.

¹⁶² RT 523:15-18 (Bouler/MWACSC).

assertion that California American Water has violated Rule 15 is simply untrue. Here, the Faught Road Well will benefit existing customers by meeting the water supply deficit, and therefore should be paid for by all customers. Furthermore, given that new customers will pay the same rates as other customers, including any contributions to plant, it is equitable that the plant installed by the utility should be paid for by all customers. Accordingly, the Commission should disregard MWACSC's contention that the Faught Road Well Project should be paid for by developers.

Finally, the Commission should disregard MWACSC's contention that Well No. 6 should be funded by developers because it is not a project at issue in this proceeding.¹⁶³

2. Larkfield Water Treatment Plant Improvements (Faught Road Well).

As set forth in the Opening Brief, California American Water requested certain improvements to the Larkfield Water Treatment Plant that are necessary to ensure that 1,200 gallons per minute of treatment capacity is available and adequate to meet the current and future well capacity.¹⁶⁴ MWACSC's sole rationale for its recommendation to disallow the \$600,000 expenditure is that this investment project is related to the Faught Road Well. This project is necessary even if the Faught Road Well is not pursued.¹⁶⁵ In addition to the treatment capacity for the new Faught Road Well, the installation of a third filter at the Larkfield Water Treatment Plant will provide a critical redundancy and ensure operational flexibility for the Larkfield Water Treatment Plant.¹⁶⁶ The replacement of the filter media, which is used in the removal of iron and

¹⁶³ California American Water removed Well No. 6 from its request in this rate case in the Direct Testimony of Thomas Glover (Exh. 14) and the Supplemental Testimony of Rodney Jordan (Exh. 15), served on April 20, 2007.

¹⁶⁴ Exh. 17, Glover Rebuttal, pp. 26-27.

¹⁶⁵ Exh. 17, Glover Rebuttal, p. 27:1-2.

¹⁶⁶ Exh. 17, Glover Rebuttal, pp. 26:27-27:1.

manganese from the groundwater supply, is necessary to maintain filter performance, capacity and the overall functionality of the Water Treatment Plant.¹⁶⁷

MWACSC seeks to improperly introduce new information regarding the operating capacity of the Water Treatment Plant that is not part of the record and has not been subject to meaningful cross-examination. Without any evidentiary support, MWACSC claims that the proposed improvements are unnecessary because the Water Treatment Plant never operates at full capacity.¹⁶⁸ MWACSC's conjecture regarding the operating capacity of the Water Treatment Plant should be disregarded.

3. North Wikiup Tank No. 2.

MWACSC's misleading assertions that California American Water did not act with reasonable managerial skill and prudence are contradicted by the facts. Because there is no evidentiary support for its allegations about the North Wikiup Tank No. 2, MWACSC resorts to espousing opinions and speculation.

California American Water provided substantial justification that the North Wikiup Tank No. 2 is a prudent investment project that was designed in compliance with the most current industry design standards and incorporated site-specific seismic criteria.¹⁶⁹ While the fault line **does not underlie the tank site** California American Water invested significant resources to assure that all risks associated with a seismic event at the North Wikiup Tank site were appropriately mitigated.¹⁷⁰ California American Water performed geotechnical

¹⁶⁷ Exh. 17, Glover Rebuttal, pp. 28-29.

¹⁶⁸ MWACSC Opening Brief, p. 13.

¹⁶⁹ Exh. 17, Glover Rebuttal, pp. 32-33.

¹⁷⁰ Exh. 17, Glover Rebuttal, p. 32 (testifying that the geotechnical report prepared by Harding Lawson Associates in 1986 demonstrates that the fault line does not underlie the proposed tank site.). *See also* RT 500:24-25 (Glover/CAW).

investigation and seismic shaking hazard analysis.¹⁷¹ California American Water took precautions above and beyond what was required to ensure that it met the most current engineering standards.¹⁷² Based upon the initial engineering studies, California American Water prepared a tank failure analysis to determine all potential risk associated with tank failure. MWACSC's criticism of the design and construction of the North Wikiup Tank No. 2 amounts to nothing more than alarmist second-guessing of California American Water's design and construction of the tank, and as such, it should be disregarded in its entirety.

Despite the substantial evidence that California American Water fully complied with the appropriate and necessary standards for seismic safety, MWACSC claims that California American Water ignored the findings in a report issued by Zinn Geology that constructing the Wikiup Tank No. 2 at the site was hazardous. It is clear that MWACSC has no interest in the truth -- California American Water has repeatedly refuted MWACSC's allegations about the safety of the North Wikiup Tank site, yet MWACSC continues to make false and highly misleading conclusions about the safety of the tank that are contradicted by the record.

First, California American Water provided evidence that its reliance upon the 1986 Harding Lawson geological report was reasonable and well-founded because that report was based upon "firsthand site inspection with the foundation stripping."¹⁷³ As Mr. Glover testified, for a 20-year-old geological report, you're not going to see that many differences, because basically you're trenching and looking at underlying geology of the area. So over 20 years, that's [] a very short period of time in geological terms."¹⁷⁴

¹⁷¹ Exh. 17, Glover Rebuttal, p. 31:22-26.

¹⁷² Exh. 17, Glover Rebuttal, p. 32.

¹⁷³ RT 502:12-13 (Glover/CAW).

¹⁷⁴ RT 490:17-21 (Glover/CAW).

Second, MWACSC's statement that California American Water relied upon this report as the only opinion is contradicted by evidence that California American Water also took into consideration additional studies that were subsequently performed, including the Zinn Geology report. As discussed above, California American Water took a number of measures to ensure that the design and the construction were adequate to handle the seismic loading that the structure might experience at the site.¹⁷⁵

In sum, the opinions of MWACSC's witness regarding the safety of the tank should be given no weight because he has no expertise in the complex seismic and environmental issues involved with the North Wikiup Tank No. 2. The Commission should disregard MWACSC's baseless allegations regarding the design and construction of the North Wikiup Tank No. 2.

There is no evidence to support MWACSC's suggestion that the Commission initiate an investigation into the safety of the North Wikiup Tank No. 2. MWACSC alleges that California American Water intentionally withheld information that the North Wikiup Tank No. 2 is located near an earthquake fault from the Commission, DRA and MWACSC concerning the tank.¹⁷⁶ Without explaining how or why the information should have been provided, MWACSC faults California American Water for not providing information about the tank before the rate case was even initiated.¹⁷⁷ MWACSC's criticism is absolutely baseless -- California American Water has not withheld any information about the proposed site for the new tank. In fact, the new tank is presently under construction at the site of the existing North Wikiup tank, which has

¹⁷⁵ RT 498:1-4 (Glover/CAW).

¹⁷⁶ MWACSC Opening Brief, pp. 14-15.

¹⁷⁷ MWACSC Opening Brief, p. 14.

been in operation for twenty years.¹⁷⁸ The new tank was identified as the ideal location in the Larkfield District's distribution system for the additional tank.¹⁷⁹

MWACSC recommends that all tank costs (beyond the \$500,000 originally requested) be disallowed, but it does not directly challenge or provide evidence as to any specific expense as unreasonable. By contrast, there is a huge volume of evidence supporting California American Water's request for the proposed expenses. First and foremost, this new tank will provide much-needed demand equalization and fire flow storage capacity for the Lower Zone of the Larkfield District's distribution system the Larkfield District. The Larkfield District does not currently have enough distribution storage capacity to suppress a fire during a maximum day event.¹⁸⁰ An analysis required under Title 22 of the California Department of Health Services regulations revealed that existing demands already show a deficit of distribution storage and that California American Water must construct additional distribution storage in the Larkfield District as soon as possible.¹⁸¹ The Comprehensive Planning Study also confirmed that the tank is needed to provide necessary distribution storage to meet projected demands and customer growth.¹⁸²

IV. CONCLUSION

For the foregoing reasons, California American Water urges the Commission to authorize California American Water's request for a return on equity of 11.5%, the ISRS program as proposed by California American Water, its rate consolidation proposal for the Sacramento and Larkfield Districts, and allowance of at least the full amount of the Regulatory

¹⁷⁸ RT 502:5-13 (Glover/CAW)

¹⁷⁹ Exh. 17, Glover Rebuttal, p. 29:18-21.

¹⁸⁰ Exh. 17, Glover Rebuttal, pp. 29-30.

¹⁸¹ Exh. 17, Glover Rebuttal, pp. 29-30.

¹⁸² Exh. 17, Glover Rebuttal, p. 30.

Expenses and Employee Pension and Benefits expenses requested by California American Water. California American Water urges the Commission to disregard MWACSC's gross distortions of the record and unfounded assertions.

Dated: July 3, 2007

Respectfully submitted,

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PROOF OF SERVICE

I, Michelle Chavez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years and not a party to this action. My business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On July 3, 2007, I served the within:

Reply Brief of California-American Water Company on the Revenue Requirements

on the interested parties in this action addressed as follows:

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Michelle Chavez

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